CONFLICTS OF INTEREST, SELF-DEALING AND CONTINGENT LIABILITIES

Conflicts of interest are discussed throughout this Manual as they relate to each of the other major sections. Conflict of interest situations and self-dealing activities are major sources of contingent liabilities, therefore, these topics are discussed together in this Section.

There is no doubt that conflicts of interest and self-dealing activities should be avoided by fiduciary, however, avoidance is not always possible. The terms "conflicts of interest" and "self dealing" are descriptive but should not necessarily be considered disparaging. For example, the use of own-bank deposits as trust investments (or assets) is by definition "self-dealing" without necessarily being abusive or detrimental to the interests of account beneficiaries.

A. CONFLICTS OF INTEREST

Simply stated, a conflict of interest generally arises when a person's or entity's duty of loyalty to another clashes with other interests of that person or entity. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

Banks and their trust departments need to formulate and formalize policies which deal with particular conflict of interest situations. The most frequently encountered situations to be addressed are set forth below. Although this list is not comprehensive, it does present issues common to the vast majority of trust institutions: (1) Purchase, retention and sale of own-institution stock or other affiliated securities; (2) Discretionary voting of own-institution securities; (3) Interaccount transactions; (4) Sale or purchase of trust assets to or from the bank, bank insiders, agents or affiliates; (5) Relationships with brokers or other agents; and (6) Use of own-bank or affiliate bank deposits.

The courts have long held that fiduciary transactions not made at "arms-length" may be set aside at the request of a beneficiary. This presumes the beneficiary was harmed by such transaction and therefore, the fiduciary assumes the consequences of that harm. Consequently, a fiduciary effectively underwrites transactions involving conflicts of interest. Own-bank deposit relationships may involve little risk, but the bank should avoid even the appearance of abuse before entering into such an apparently innocuous relationship. Where more onerous situations are encountered, e.g., purchase or retention of own-institution stock or sale of a trust asset to a bank insider, fiduciaries must exercise extreme caution in properly discharging their duties. Complete documentation supporting the bank's use of caution and the prudence of such transactions should be readily available. It is not unusual for banks to seek court sanction of particularly sensitive transactions involving self-dealing or conflicts of interest. Certainly, opinions of counsel provide both guidance and supporting documentation.

Among the areas giving rise to conflict of interest situations are insider transactions. A corporate fiduciary must exercise great care when dealing with obligations of its directors, officers, employees, shareholders or their interests. Purchase of obligations of this nature should not be made unless lawfully authorized by the instrument creating the trust relationship, court order, local law, or prior written approval has been obtained from all interested parties. While retention of such securities when received "in kind" may be allowable under a general power of retention, a trustee should exercise caution when making the decision to retain. It is recommended that the examiner encourage the bank to fully document its reasons for retaining assets of this nature. The documentation should include a statement as to the authority to purchase and/or retain the obligation, the factors which make the obligation a sound investment, and reasons why the obligation is a good investment for the respective account.

Examiners should be alert to conflict of interest situations, both actual and potential, and should direct their efforts to an evaluation of a bank's actions or lack of actions to adequately protect the beneficiaries of a fiduciary relationship. Situations involving the self-interest and duty of loyalty of the bank as trustee should receive the examiner's special attention and be disclosed in the report of examination in an appropriate manner depending on the circumstances involved. Where definite conflict of interest dealings are revealed, the examiner should fully disclose the matter in the report and recommend to management that adequate and appropriate measures be taken to correct the situation. In discussions with bank management and in completing the report of examination, the examiner obviously must exercise the utmost care and accuracy in the treatment of instances involving possible trustee conflicts of interest.

B. SELF-DEALING

Self-dealing activities always involve conflicts of interest but not all conflicts of interest involve self-dealing. The latter is limited to a trustee dealing with itself or an affiliate in sale of bank assets to a trust or the reverse, sale of assets between accounts, and transactions involving own-stock or other obligations including deposits. Dealing with insiders involves conflicts of interest but is technically not self-dealing, though the potential for abuse is no less menacing.

A clear statement of law regarding self-dealing was expressed by the U.S. Supreme Court in Michoud v. Girod, 11 L.Ed. 1076, 1099:

"The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity. . . . It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells."

As such transactions may be set aside within a reasonable time after notice at the insistence of the beneficiary, a trustee may be liable for damages resulting from, among other things, depreciation or loss of income. The prohibition against self-dealing applies with equal force to affiliates.

For the same reasons, a bank should not invest fiduciary funds in its own obligations or stock. When any such obligations are received "in kind", the bank should use diligence in selling such assets at an early date unless the trust instrument, court order or local law authorizes the purchase and retention of such securities or specific authority has been obtained from all interested parties to retain the assets in the fiduciary account. As in the case of obligations of directors, officers, employees, shareholders or their interests, the bank should fully document its reasons for retaining its own obligations or stock. Refer to Deposits with Self below for further discussion.

C. CONTINGENT LIABILITIES

Certain definite principles and rules of action governing fiduciaries have been laid down by statues and court decisions. A violation of any of these principles and rules of conduct or failure to carry out the terms of the trust instrument or court order may create a potential liability. Whether or not this liability is transferred from a contingent liability to an actual liability depends upon the actions of the parties.

Contingent liabilities represent an estimation by the examiner of the gross possible liability of the institution resulting from the purchase of nonconforming investments for trust accounts, unwarranted retention of nonconforming assets, self-dealing, questionable practices and procedures, or other acts of omission or commission which appear not to comply with the terms of the governing trust instrument or applicable provisions of law, and upon accounting may be subject to objection by interested parties. Until appropriate consents, waivers or releases of liability are obtained from interested parties or nonliability is determined by a court of competent jurisdiction, the liabilities are regarded as "contingent". Conflicts of interest and self-dealing were discussed earlier; discussion of several other types of contingent liabilities follows.

Contravention of the Terms Trust Instruments - Insofar as the trust instrument expressly or by implication imposes duties or confers powers upon a trustee, the trustee commits a breach of trust if it does not perform the duties or exercise the powers conferred in accordance with the terms of the instrument. An exception exists where the performance of such duties or the exercise of such powers is or becomes impossible, the provision is illegal, or there has been such a change of circumstances as to justify a deviation from the terms of the trust. In the absence of an emergency, a trustee should always seek and obtain authorization from a court of competent jurisdiction before deviating from the terms of a trust.

Commingling - The assets of each fiduciary account should be kept separate from both the assets of other fiduciary accounts and the assets of the bank. There should be no commingling. In carrying out this responsibility, the bank should earmark all assets with the name of the fiduciary account. For example, mortgages, deeds, stocks, registered securities and obligations should be in the name of the bank as fiduciary for the account or in the name of a nominee. If the bank is acting in a capacity such as agent or custodian, registration would be in the name of the principal unless otherwise directed by the agreement. In many states a trustee may deposit uninvested funds belonging to several trust accounts in a single deposit account. However, the account must be designated as a fiduciary deposit account and the records of the trust department reflect the separate interests of each fiduciary account in the deposit balance. The examiner should become familiar with those state statutes that permit certain types of commingling.

Legal Lists and the "Prudent Man Rule" - Some states have enacted statutes listing assets in which the bank may invest the funds of fiduciary accounts. The examiner will have to determine whether the statute merely permits the bank to invest in the named securities or requires investment only in the named assets. If the statue is permissive rather than mandatory, there appears to be no reason the bank cannot make investments outside of the approved list. However, if it does so, it will be required to use the care of an ordinarily prudent businessman.

The "Prudent Man Rule" or Massachusetts or American rule, applies in those states where there is no statutory list relating to the type of investments required or permitted by trustees. In the case of Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), the Supreme Judicial Court of Massachusetts said:

"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

In some states, however, the Massachusetts rule has been altered to specify that, unless otherwise required by the terms of the trust, trust funds may be invested in such securities as an ordinarily prudent man of intelligence and integrity who is a trustee of the monies of others would purchase.

Should the trust instrument direct the bank to make certain investments outside the statutory list, it will be liable if it fails to follow the terms of the trust instrument, unless the bank is relieved from complying with the terms by a court of competent jurisdiction in an action wherein all of the necessary parties have been afforded proper notice and an opportunity to be heard.

Unless otherwise provided by the terms of the trust, statute or court order, the bank (trustee) is under a duty to dispose of nonconforming assets and properly reinvest the funds within a reasonable time after accepting the trust. Failure to do so exposes the bank to liability. What is a reasonable time depends upon the circumstances of each case.

Real Estate Mortgages and Real Estate - Loans secured by real estate mortgages or deeds of trust appear to be permissible investments for trust funds in all states. The examiner will determine from the statutes or decisions the limit that may be loaned on bonds or notes secured by real estate. If a loan exceeded the limit when made, it should be reported. Loans secured by second mortgages are generally disapproved by courts of equity and each such loan should be listed unless unusual circumstances exist.

In the absence of directions in the trust instrument or of special circumstances, the bank should be extremely cautious in investing trust funds in real estate. The bank, if directed to furnish the beneficiary with a home, may purchase real estate rather than rent, but in such case should first obtain court approval. The bank may bid on property at a foreclosure sale in order to protect the beneficiary's equity, but it should dispose of the property as soon as a reasonable price can be obtained.

Deposits with Self - Many states by statute or court decision permit a bank acting in a fiduciary capacity to deposit uninvested trust funds in other departments of the bank for a reasonable length of time while awaiting investment. Some states have by statute or court decision adopted the doctrine that a bank may not commingle uninvested trust funds with its own funds unless adequately protected by pledged assets. Where the bank allowed to deposit uninvested trust funds in other departments, the examiner should determine that the pledged assets are in conformity with the statute or court decision as to amount and type.

The deposit of uninvested trust funds with those of the bank's own commercial department is clearly a self-dealing transaction. However, where permitted by statute or court order, it becomes more a question of proper management of the conflict by the bank. Generally, the combined income and principal cash of the department's accounts is deposited in one account. The point is not the amount on deposit, but the reasonableness of the uninvested balances of the individual accounts. Balances of fiduciary accounts must be kept at the minimum possible level. Consequently, there should be a formal system for monitoring and reviewing uninvested funds in all except the smallest departments. The examiner should determine that the bank's policies and procedures are proper.

The purchase of certificates of deposit of the trustee bank or its affiliates is without question a form of self-dealing. However, it is specifically authorized in many trust instruments and/or permitted by state statute. Therefore, it often becomes a matter of conflicts which are not prohibited but must be carefully controlled and managed to ensure that the interests of beneficiaries are protected. The examiner must recognize that even in those situations where such purchases are authorized by the instrument and/or permitted by statute, the transaction must be made in good faith. This requires the fiduciary to have considered alternative investment media and determined that the purchase is both prudent and proper for the account considering the alternatives available at the time of the transaction. The general supervisory approach in this situation is that the amount invested in own-bank savings and time deposits for each account should not exceed Federal deposit insurance coverage unless the excess is adequately secured by pledged assets. Interest rates should be competitive and the investment consistent with account objectives.

One aspect of the conflict situation that merits examination attention is the overall volume of own-bank deposit investments held by accounts over which the bank has investment discretion. Although the individual account investments may be within deposit insurance coverage limits and bear competitive rates, the pattern of investment practices by the department could be such as to expose the institution to claims the investments were not made in good faith considering the fiduciary's duty of loyalty to the beneficiaries.

As with other own-bank related investments, the department should fully document its review of alternative investment vehicles, the competitive nature of the interest rates, and its approval procedures with a view to protecting the interests of the institution.

Acts Without Consent or Approval of Co-Fiduciary
Co-fiduciaries should execute the duties of their office in their joint capacity. Where discretion and judgment are required, as distinguished from purely ministerial acts, joint action of the trustees is required unless the trust instrument or applicable statute provides otherwise. A sale or purchase of securities is held to involve an exercise of discretion or judgment and requires joint action of the co-fiduciaries and should have

their written approval. Where such approval is not in the file, the examiner should make appropriate comment to that effect in the report of examination.

<u>Failure to Invest</u> - Unless the trust instrument, court order, a party empowered to direct investments, or local law provides otherwise, all funds including both the income and principal cash of an account should be made productive by the fiduciary. Should it fail to carry out this duty it may be liable for loss of income. If it were under duty to invest in a certain named investment it may be liable for the loss of the increase in value of the principal should the asset have risen in value. It is the account administrator's decision as to how much cash should be invested. Any decision to leave cash uninvested must be properly supported and documented in the bank's records.